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## BEFORE THE ARIZONA CORPORATION COMMISSION

BOB STUMP  
Chairman

2014 AUG -7 A 9:01

GARY PIERCE  
Commissioner

ARIZONA CORPORATION COMMISSION  
DOCKET CONTROL

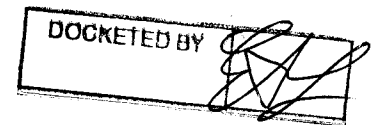
BRENDA BURNS  
Commissioner

ORIGINAL

Arizona Corporation Commission  
DOCKETED

AUG 07 2014

BOB BURNS  
Commissioner



SUSAN BITTER SMITH  
Commissioner

IN THE MATTER OF THE COMMISSION'S )  
INQUIRY INTO THE POSSIBLE )  
DEVELOPMENT OF REGULATORY )  
POLICIES AND STRATEGIES TO )  
EVALUATE AND POTENTIALLY )  
ENCOURAGE CONSOLIDATION )  
CONCERNING ARIZONA'S WATER AND )  
WASTEWATER UTILITIES INDUSTRY. )

DOCKET NO. WS-00000A-14-0198

**EPCOR WATER COMPANY'S  
RESPONSE TO RESPONSIBLE  
WATER/RUCO PAPER AND  
RELATED TOPICS.**

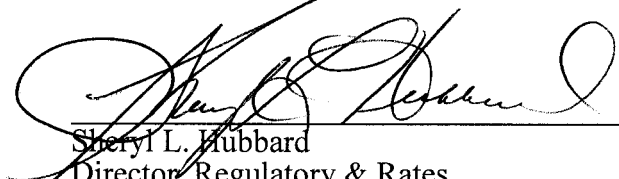
EPCOR Water Arizona, Inc. ("EPCOR" or "Company") is encouraged by and fully supports the Arizona Corporation Commission's ("ACC") initiative to look into the possible development of regulatory policies and strategies to evaluate and potentially encourage consolidation.

The National Association of Water Companies (NAWC) has coordinated with EPCOR to produce a paper on this subject which is attached as Attachment A. Both organizations appreciate that the ACC has recognized this as a critical issue and agree that policies that encourage system acquisition and consolidation are not only helpful, but necessary. We hope that this paper helps further inform the Commission and other involved stakeholders on the need for a lasting consolidation strategy that will increase system resilience and reliability, help address rising costs, and increase economic and regulatory efficiency.

System consolidation will help address the long-term sustainability of water and wastewater service in Arizona. A statewide consolidation strategy should include policies that address both troubled and non-troubled systems, because there are two distinct goals to consider. By encouraging the acquisition of troubled systems, the Commission is addressing potential health and safety issues; by incenting the consolidation of non-troubled systems, the Commission is encouraging greater long-term economic and regulatory efficiency and the sustainability of our scarce water resources.

There has long been a compelling case to consolidate the water and wastewater industries in Arizona, but policies that will achieve that are complex and not widely understood. We recommend that the Commission adopt mechanisms that support and encourage consolidation of the regulated water and wastewater industries. We feel that larger, more efficient systems will be better equipped to respond to Arizona's complex water situation, its scarce resource development and reliable delivery to address the future challenges of a growing population.

RESPECTFULLY SUBMITTED this 7th day of August, 2014.



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EPCOR Water  
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Phoenix, AZ 85027

ORIGINAL and thirteen (13) copies  
of the foregoing filed  
this 7th day of August, 2014, with:

The Arizona Corporation Commission  
Utilities Division – Docket Control  
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Phoenix, Arizona 85007

Copy of the foregoing hand-delivered  
this 7th day of August, 2014, to:

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## **Encouraging Long-Term Sustainability of Water Service through Consolidation**

The National Association of Water Companies (NAWC) has coordinated with EPCOR Water USA to offer the following comments and recommendations to the Arizona Corporation Commission (ACC or “the Commission”) on the strategies to consolidate the water and wastewater industries across the state. Both organizations appreciate that the ACC has recognized this as a critical issue and agree that policies that encourage system acquisition and consolidation are not only helpful, but necessary. We hope that this paper helps further inform the Commission and other involved stakeholders on the need for a lasting consolidation strategy that will increase system resilience and reliability, help address rising costs, and increase economic and regulatory efficiency.

### **A Needlessly Fragmented Market**

Like many states, Arizona has a handful of regulated electric and natural gas utilities, but over 300 water utilities, most of them serving a small service territory. This fragmented market structure has evolved with population growth and property development across the state, and thus exists for historical reasons, but runs counter to the foundational economic principles of regulated utilities. The water services industry like other network industries delivers maximum mutual benefit when achieving economies of scale, meaning that large utilities are able to invest capital and provide specialized, professional management at a lower per-customer cost because those costs are spread over a larger customer base. The market structures for electric and natural gas utilities in Arizona reflect that economic principle, but the water industry does not. In our view, there is no structural justification for this considerable fragmentation of the market and that this problem can be solved through carefully considered regulatory policies.

System consolidation will also help address the long-term sustainability of water and wastewater service in Arizona. Large systems are better equipped to deal with environmental challenges, infrastructure upgrading and replacement, and customer communication. Furthermore, most existing private water company service territories in Arizona correspond to areas with the highest projected population increases over the next few decades. Encouraging the consolidation of smaller systems in those areas will deliver the benefits of scale to growing population areas.

The Commission has long recognized the need for and potential benefit of water industry consolidation, dating back at least to the recommendations of The Commission's Water Task Force in 1998 and, more recently, through a number of water workshops hosted by the Commission in 2011. While this recognition is critical, the main challenge lies in crafting policies that drive further consolidation by providing greater certainty on the transaction between the parties.

## **Adopting Effective Policies**

A statewide consolidation strategy should include policies that address both troubled and non-troubled systems, because there are two distinct goals to consider. By encouraging the acquisition of troubled systems, the Commission is addressing potential health and safety issues; by incenting the consolidation of non-troubled systems, the Commission is encouraging greater long-term economic and regulatory efficiency.

A number of states have successfully implemented consolidation and acquisition policies that could serve as models for a policy or policies that are adopted by the Commission.<sup>1</sup> It should also be noted that the ideas conveyed in this paper are consistent with certain best practices recognized by the National Association of Regulatory Utility Commissioners (NARUC). In addressing those practices that can benefit healthy and functioning small systems, NARUC recommends that state utility commissions encourage "consolidation with a nearby water system... where applicable and beneficial to the customer."<sup>2</sup>

It is our recommendation that the following policies or practices be considered:

- Acquisition adjustments
- Independent valuation or appraisal processes
- Return on equity premiums
- Rate consolidation
- Direct engagement of unsustainable small systems

These policies must be clearly defined and transact able so as to give the market certainty on outcomes and investment returns.

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<sup>1</sup> See: Pennsylvania utility statute 69.711; Missouri statute Chapter 393; Illinois HB1379

<sup>2</sup> NARUC, "Resolution Supporting the Consideration of Regulatory Mechanisms and Policies Deemed 'Best Practices' for the Regulation of Small Water Systems" Adopted July 2013

*Acquisition adjustments:*

An acquisition adjustment or premium is the most typical example of a ratemaking mechanism that can be used to promote consolidation. In some cases, a water company will buy another company for more than book value. The acquiring company will then ask the Commission to adopt the purchase price (or some value greater than book value) as the beginning original cost value for determining rate base. The resulting rate base, which is higher than book value, is reflected in rates for the acquired company's customers that are higher than they would have been, absent the consolidation. However, the acquisition ostensibly delivers long-term benefits of scale to all customers – both existing and new – and can deliver short-term benefits to the customers of the acquired company through improved financial status, professional operations and expertise.

*Independent valuation or appraisal:*

One potential downside of an acquisition adjustment is that it could incent either buyer or seller to increase the purchase price. Because the parties to the transaction would know that the Commission would be likely to include the purchase price in rate base, sellers would be more likely to hold out for purchase prices that exceed book value, and buyers would be more likely to agree to an inflated purchase price. One safeguard that would reduce the incentive to game the process and reduce contentious steps in the acquisition process would be to have an independent valuation process. We recommend that Arizona consider using valuations from three independent, outside appraisers and either taking the average of the three (ex: Illinois) or ask that the three appraisers agree on a valuation (ex: Missouri). This is also critical when applying an ROE premium.

*Return on equity (ROE) premiums:*

Several jurisdictions have chosen to avoid the potential perverse incentives of an acquisition premium by adjusting the acquiring company's authorized return on equity (ROE) to reflect the additional risk adopted through the transaction. It is recommended that the Commission consider not only the risk of expanding service and any necessary system improvements to bring the system up to compliance, but also the additional risk that might be inherent to acquisition. Acquiring a troubled system in itself is risky and could lead to increased operating costs and unforeseen investment requirements.

#### *Rate consolidation:*

Rate consolidation is prevalent across electric and natural gas utilities, but has not been widely adopted in the regulated water services industry. In addition to further encouraging economies of scale (and the associated customer benefit), consolidating rates across affiliated systems increases the efficiency of the regulatory process and the continued propagation of small isolated rate cases fully vetted under larger class utilities' standards. Utilities are also better equipped to respond to events (storms, unforeseen infrastructure issues, etc.) that could affect one part of their expanded service territory, while spreading the cost over a greater number of customers.

#### *Direct engagement with unsustainable systems:*

Jurisdictions that have effectively reduced the number of water systems in their state have also directly engaged small utilities to identify those systems that are unsustainable, either because of non-compliance, underinvestment, or waning interest. These direct interactions vary from truly staff assisted rate cases, with the objective of increasing critical investment in order to bring the system into compliance, to periodic and routine outreach from the commission staff to system owners. Systems failing to comply with required standards need to be encouraged to consolidate with larger systems.

## **Summary & Final Recommendation**

There has long been a compelling case to consolidate the water and wastewater industries in Arizona, but policies that will achieve that are complex and not widely understood. In weighing the available options, we encourage the Commission to consider how each mechanism would impact transparency, both for the companies involved and for consumers, affect regulatory certainty (and thus investment), and address risk for the companies involved.

Arizona will continue to see significant population growth in the coming decades and many of these new residents will be served by the private water and wastewater service industry. In order to ensure the sustainability of those services in the long-term, we recommend that the Commission adopt mechanisms that support and encourage consolidation of the regulated water industry. We feel that larger, more efficient systems will be better equipped to respond to Arizona's complex water situation and the future challenges of a growing population.